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Supreme Court of the United States

OCTOBER TERM, 1998

LASZLO N. TAUBER, SAMUEL BURTOFF, MICHAEL A. CORRADO, DAN J. FERIOZI, IRWIN S. FREEDMAN, LESLIE P. GONDOR, REGINALD P. MCMANUS, LESLIE L. PETERS, MAGDOLNA A. IRANYI, JAMES H. SCULLY, JEFFERSON MEMORIAL HOSPITAL ASSOCIATES, JEFFERSON MEMORIAL HOSPITAL JOINT VENTURE, and JEFFERSON CORPORATION OF ALEXANDRIA,

Petitioners,

v.

COMMONWEALTH OF VIRGINIA, *ex rel.* MARK EARLEY, ATTORNEY GENERAL OF THE COMMONWEALTH OF VIRGINIA; MARK EARLEY, ATTORNEY GENERAL OF THE COMMONWEALTH OF VIRGINIA and THE COMMONWEALTH'S ATTORNEY FOR THE CITY OF ALEXANDRIA,

Respondents.

On Petition for a Writ of Certiorari to the Virginia Supreme Court

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REPLY BRIEF OF PETITIONERS

GASPARE J. BONO
Counsel of Record
LEE H. SIMOWITZ
JAMES M. BURNS
BAKER & HOSTETLER LLP
1050 Connecticut Ave., N.W.
Suite 1100
Washington, D.C. 20036
(202) 861-1500
Counsel for Petitioners

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REPLY BRIEF OF PETITIONERS

Petitioners Laszlo N. Tauber, Samuel Burtoff, Michael A. Corrado, Dan J. Feriozi, Irwin S. Freedman, Leslie P. Gondor, Reginald P. McManus, Leslie L. Peters, Magdolna A. Iranyi, James H. Scully, Jefferson Memorial Hospital Associates, Jefferson Memorial Hospital Joint Venture and Jefferson Corporation of Alexandria respectfully submit this reply brief in further support of their

petition for a writ of certiorari to review the judgment and opinion of the Virginia Supreme Court.

INTRODUCTION

The Brief in Opposition filed by the Commonwealth of Virginia, the Attorney General of the Commonwealth of Virginia and the Commonwealth's Attorney for the City of Alexandria ("respondents") amply demonstrates why this Court should hear this matter on the merits. Petitioners' brief showed that the Virginia Supreme Court's failure to apply the internal affairs doctrine violated constitutional principles, conflicted with the decisions of virtually every other court that has considered the issue, and created untenable consequences for corporate boards across the country. Respondents offer no real response, failing to address these issues directly, indirectly, or even tangentially. Instead, respondents attempt to divert this Court's attention away from the significant legal issue presented by petitioners by addressing a completely different and non-existent issue having nothing to do with this case or the matter before this Court. Such a tactic is inappropriate and duplicitous. Petitioners respectfully renew their request that this Court grant their petition and hear and decide the important constitutional issues raised in their petition.

In their opposition brief, respondents attempt to argue that the Virginia Supreme Court's decision to uphold the trial court's application of Virginia law in this action (rather than Maryland law under which the nonprofit institution at issue was formed and operated) was constitutional because the law in Virginia concerning breaches of fiduciary duty by *trustees-in-dissolution* is "totally consonant" with Maryland law. However, this proposition, even if accurate (which petitioners do not concede), constitutes no response at all to the constitutional issue presented here. The issue raised in the petition (and the issue tried below) concerns whether petitioners breached their fiduciary duty in their capacity as the *Board of*

Trustees of a then-operating nonprofit hospital by authorizing the transfer of all of its assets to a for-profit corporation in return for the assumption of the nonprofit's liabilities by the for-profit corporation, and *not* whether petitioners breached their fiduciary duties after they had been converted by operation of law to *trustees-in-dissolution.* Consequently, the applicable law on breach of fiduciary duty implicated by this case (and as to which a choice between Maryland and Virginia law was required) is the law respecting insider corporate transactions, *not* the law concerning the duties of trustees-in-dissolution.

As demonstrated below, a conflict *does* exist between Maryland law and Virginia law on this subject. The Virginia trial court imposed liability on petitioners under Virginia law, thus rendering its failure to apply the internal affairs doctrine an error of constitutional proportions. Moreover, petitioners will first demonstrate that respondents' contention that petitioners have "created an issue that simply does not exist" is categorically incorrect. As is clearly shown below, the alleged breach of fiduciary duty asserted here involves conduct taken by a *Board of Trustees* operating a nonprofit hospital, and not an alleged breach by *trustees-in-dissolution.*

I. THE DECISIONS BELOW CLEARLY DEMONSTRATE THAT THE ALLEGED BREACH OF FIDUCIARY DUTY ASSERTED HERE INVOLVED ACTIONS TAKEN BY A BOARD OF TRUSTEES OPERATING A NONPROFIT HOSPITAL, AND NOT AN ALLEGED BREACH BY TRUSTEES-IN-DISSOLUTION

Despite respondents' contrary contentions, it is undeniably clear that this case concerns an alleged breach of fiduciary duty by petitioners in their capacity as a Board of Trustees, not as trustees-in-dissolution. The Virginia trial court's decision expressly addressed whether petitioners, as directors (*i.e.*, as the *Board of Trustees*

since the entity was a nonprofit institution), breached their fiduciary duties to that nonprofit institution when, in 1971, they transferred all the nonprofit's assets to a newly created for-profit corporation in return for the for-profit's assumption of the nonprofit's liabilities. Contrary to respondents' current suggestions, the Virginia trial court did not focus upon whether petitioners violated their fiduciary duties in connection with the formal dissolution of the nonprofit in 1973. The trial court's opinion could not be more clear. The court specifically held that "documents indicate that JMHC (the for-profit) assumed all of the liabilities of the charity in return for its assumption of JMHI (the nonprofit) assets," (16A) and the trial court held that this change in corporate form occurred in 1971. (17A; "The Court finds that *in 1971, the time of the change to for-profit*, . . ." (emphasis added)).

Moreover, further evidence that the trial court's decision centered upon whether petitioners, as a board of trustees and *not* as trustees-in-dissolution, had breached their fiduciary duties is amply provided within the four corners of the court's opinion. Significantly, the conduct that the court points to as constituting a breach of duty is conduct *prior* to 1973, which is the date on which by operation of law petitioners first became trustees-in-dissolution. Most telling on this issue is the fact that the trial court, in assessing whether a breach had occurred, expressly analyzed whether the 1971 transaction was fair to the nonprofit hospital, not whether any post-dissolution conduct constituted a breach of duty. The Court stated:

> [Petitioners'] claim that JMHI had no value at the time it was changed to a for-profit corporation and, therefore, the transactions by which they assumed control of the corporate assets by the assumption of its liabilities were fair. . . *The Court finds that in 1971, the time of the change to for-profit*, the corporation (JMHI) had value. . . . *However*, [*petitioners'*] *experts are the more persuasive and the Court*

finds that [*petitioners*] *have carried their burden of showing that the value of the corporation did not exceed its liabilities.*

17A (emphasis added).

Petitioners have consistently maintained that this finding constituted a complete defense to respondents' claims and, had Maryland law been applied, a finding of no liability for breach of fiduciary duty would have been compelled. *Chesapeake Construction Corp. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970) (an insider transaction involving corporate directors is not void where the transaction is fair to the corporation); *see also* Md. Code Ann., Corps. & Ass'ns. § 2-419 (Michie 1993). However, the trial court expressly stated that the fairness of the transaction "does not constitute a defense to the claims made here for reasons that follow," (17A) and proceeded to apply Virginia law to that conduct, citing and relying upon *Rowland v. Kable*, 174 Va. 343 (1970), *Deford v. Ballentine Realty Corporation*, 164 Va. 436 (1935) and *Kessler v. Commonwealth Doctors Hospital*, 212 Va. 497 (1971). The trial court then concluded that the fairness of the transaction was not a defense to respondents' claims, because "the actions of the directors are voidable at the option of the beneficiaries of the trust imposed upon them *without proof of an actual injury*" under Virginia law. 18A (emphasis added). Significantly, here too, the trial court was expressly imposing liability on petitioners as *directors*, not as trustees-in-dissolution, further belying respondents' mischaracterization of the case below.

In failing to apply Maryland law to the issue of whether petitioners' conduct, as a Board of Trustees of a nonprofit hospital, constituted a breach of fiduciary duty, the trial court violated the internal affairs doctrine, and denied petitioners the defense to the action that constitutional safeguards mandated. *John Hancock Mut. Life Ins. Co. v. Yates*, 299 U.S. 1978 (1936) (Georgia court required

to give effect to statutory defense available under New York law but not available under Georgia law). As fully described in petitioners' opening petition, this ruling was inconsistent with virtually every other case that has considered similar choice of law issues, violated fundamental constitutional principles, and threatens corporate decision-making throughout the country, especially for boards of nonprofit institutions.

Consequently, petitioners sought review of the trial court's ruling by the Virginia Supreme Court, expressly arguing that the trial court had erred in assessing petitioners' conduct under Virginia law. However, as described in petitioners' opening brief, the Virginia Supreme Court, after acknowledging that "[Petitioners] and their supporters think this case involves the improper meddling by the Commonwealth into the internal affairs of a Maryland Corporation, contrary to settled law and violative of the Full Faith and Credit, Due Process and Commerce Clauses of the United States Constitution," (10A) inexplicably concluded that "this case involves none of the above." 10A. To reach this improper conclusion, the Virginia Supreme Court adopted the erroneous proposition that respondents would have this Court accept, namely that the case pled by respondents and tried to the trial court involved a breach of duty by trustees-in-dissolution, and *not* conduct by a Board of Trustees operating the nonprofit entity.

However, as demonstrated above (and as is apparent from the trial court decision itself (13A-22A)), that contention is simply wrong. Indeed, as the Virginia Supreme Court decision (1A-12A) expressly notes, respondents' complaint specifically alleges that "assets received by [petitioners] as directors and trustees of a charitable corporation [*not* as trustees-in-dissolution]" were improperly used, and expressly challenges "the purported merger between JMHI and JMHC in *1971*," (3A; emphasis added), which was clearly taken by petitioners when they consti-

tuted and acted as the nonprofit's Board of Trustees, *not* as trustees-in-dissolution. Nevertheless, the Virginia Supreme Court refused to apply the law applicable to insider corporate transactions to this case, and in so doing erroneously side-stepped the important choice of law issue and constitutionally-based internal affairs doctrine to which petitioners were entitled.

The Virginia Supreme Court's error likely stems from its failure to distinguish between a merger and a transfer of assets. While it properly adopted the trial court's finding that a "merger" as such between a nonprofit and for-profit entity was prohibited by Maryland law, a transfer of assets and liabilities was not barred. *See* Md. Code Ann., Corps. & Ass'ns., § 5-207. Accordingly, the 1971 transaction must be addressed, and the internal affairs doctrine is unquestionably implicated. The trial court clearly appreciated this, as it did not end its analysis at whether a "merger" was permitted, but reached the merits of the transfer and imposed liability only because it applied Virginia law and refused petitioners the "fairness" defense to which they were entitled under governing Maryland law.

Because the Virginia Supreme Court's analysis so clearly departed from the matter tried below, petitioners filed a petition for rehearing addressed to this specific issue (*i.e.*, had the Virginia Supreme Court intended to reverse the trial court's finding that liability attached to petitioners' pre-1973 conduct and "affirmed" the judgment only with respect to post-1973 conduct, as to which the record below was not fully developed and as to which the trial court had not spoken). As petitioners explained, only if the Virginia Supreme Court had intended such a result (which the record would not support), could it have properly concluded that the internal affairs doctrine raised by petitioners was not applicable here. Upon the Virginia Supreme Court's denial of petitioners' request for rehearing, petitioners filed a petition with this Court, focusing on the facts actually tried below (the alleged

breach of fiduciary duty by a Board of Trustees) and the failure by the Virginia courts to apply the internal affairs doctrine, in derogation of petitioners' constitutional rights.

II. THE INTERNAL AFFAIRS DOCTRINE REQUIRED THAT MARYLAND LAW RESPECTING CORPORATE INSIDER TRANSACTIONS BE APPLIED AND COMPELLED A VERDICT FOR PETITIONERS, AND THUS THE FAILURE BY THE COURTS BELOW TO APPLY THE INTERNAL AFFAIRS DOCTRINE TO THE CHOICE OF LAW ISSUE IN THIS CASE CONSTITUTED AN ERROR OF CONSTITUTIONAL PROPORTIONS

Focusing on the actual issue in this case, it is undeniably clear that the failure of the Virginia courts to apply the internal affairs doctrine, which required the application of Maryland law respecting corporate insider transactions, constituted reversible error and deprived petitioners of their constitutional rights. It is significant that respondents do not contest that the application of Maryland law on this subject would have resulted in a verdict for petitioners, nor could they credibly do so in light of *Chesapeake Construction Corp. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970) (an insider transaction involving corporate directors is not void where the transaction is fair to the corporation). Accordingly, the failure by the Virginia courts to apply controlling Maryland law on this subject violated the Full Faith and Credit, Commerce and Due Process Clauses of the United States Constitution, as expressed in *Order of United Commercial Travelers of America v. Wolfe*, 331 U.S. 586, 589 (1947) (holding that the Full Faith and Credit Clause requires that a state "respect the laws of [a] sister state pursuant to which [an] organization has been formed"), *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982) (holding that the Commerce Clause rendered unconstitutional an Illinois statute that purported to regulate corporations "that are not incorporated in Illinois"), and *Allstate Insurance Co. v. Hague*, 449 U.S. 302, 326 (1981) (holding that

a choice of law decision violated the Due Process Clause where it is "fundamentally unfair to either litigant").

Moreover, as vividly demonstrated in the brief filed by the *amici*, this fundamental error not only denied petitioners their constitutional rights, but portends adverse consequences for all nonprofit institutions operating in multiple states. As noted by the *amici*, "the threat of multiple liability based on varying fiduciary standards [created by the lower court decisions] will not only steer able people away from nonprofit service; it will tend to force officers and trustees of nonprofits to adhere to the most severe state governance standards on the books, chilling much-needed innovation and deterring creative decisionmaking." Brief for Amici Curiae American Council on Education and National Association of State Universities and Land Grant Colleges at 7.

Accordingly, petitioners respectfully submit that for respondents to contend that this petition "does not present real or substantial federal issues" (Opposition at 13) and to suggest that it is "wholly unsubstantial and frivolous as to be devoid of any merit" (*id.* at 14) is disingenuous and offensive. Petitioners respectfully request that this Court grant the writ and hear this important matter.

CONCLUSION

For all of the foregoing reasons, as well as those set forth in their opening brief, petitioners respectfully request that their Petition be granted, and that they be permitted to present these issues to this Court for further consideration.

Respectfully submitted,

GASPARE J. BONO
Counsel of Record
LEE H. SIMOWITZ
JAMES M. BURNS
BAKER & HOSTETLER LLP
1050 Connecticut Ave., N.W.
Suite 1100
Washington, D.C. 20036
(202) 861-1500
Counsel for Petitioners

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